
Incentive Creation As The Key To Incentive Regulation

Adonis Yatchew, Ph.D.

Presentation on Behalf of the Coalition of Large Distributors
Ontario Energy Board Technical Conference
September 2006

Key Messages

1. Conventional Price-Cap Regulation of Government-Owned Firms May Not Be Effective

- ❑ The proposed price-cap rule is simple and transparent, thereby easing regulatory burden for the regulator and for utilities. However, there is little evidence to date that conventional price-cap regulation of government-owned firms is effective.
- ❑ Additional steps need to be taken to ensure that appropriate incentives are created to improve performance.

Key Messages

2. There is a Need for Incentive Creation

- ❑ Utilities may have a disincentive to achieve further efficiency improvements at this time if the resulting cost savings could be “clawed back” in the near future through rebasing.
- ❑ A mechanism which ensures that utilities continue to benefit from cost savings for a substantially longer period of time should therefore be considered.

Key Messages

3. Political Risk Needs to Be Managed

- ❑ The appropriation of distributor returns by the Provincial Government is inconsistent with incentive regulation.
- ❑ The regulator may consider it appropriate to take political risk into account when calibrating price-cap rules and when determining appropriate rates of return.

Key Messages

4. Modifications to the Price-Cap Proposal

- There is a risk that important capital programs could be delayed as a result of the proposed price-cap rule.
- Given these and other cost pressures, it may be appropriate to delay implementation of the “*K*-factor” and to rely upon an interim price-cap rule of the form $\% \Delta P = \% \Delta GDPPI - X + Z$.

Incentive Regulation

- ❑ **Competition** -- private property, market forces, market participants respond to economic incentives.
- ❑ **Regulation** – limitations / controls on economic behaviour, a planning approach, public ownership.
- ❑ **Incentive regulation** – combines elements from each. The key objective is incentive creation.

Incentive Regulation

- ❑ Price cap regulation is the most common form of performance based or incentive regulation.
- ❑ Empirical evidence suggests it is beneficial when applied to private sector companies.
- ❑ The extent to which the conventional price-cap approach has been effective in public sector is unclear.

Incentive Regulation

- ❑ Private companies are more amenable to conventional incentive regulation:
 - ❑ shareholders can sell shares signaling disaffection, leading to a decline in share price;
 - ❑ if the company under-performs, management and even the Board can be replaced;
 - ❑ if the company exceeds expectations, there is greater scope for rewarding management / executives;
 - ❑ companies are generally allowed to earn and retain additional returns for a period of time.

Incentive Regulation

- For public firms, the potential for spontaneous incentive creation is more limited:
 - government / taxpayers are collective owners, individual shares cannot be sold;
 - owner interests are diffuse and indirect;
 - there is generally less flexibility in rewarding employees for exceptional company performance and in effecting changes to management if the company performs poorly;
 - public firms are frequently used as instruments of public policy.

OEB Staff Proposal

□ Proposed interim price cap rule

$$\% \Delta P = K + \% \Delta GDPPI - X + Z$$

- $\% \Delta P$ is annual percentage change in price
- K is the adjustment for cost of capital
- $\Delta GDPPI$ is the annual percentage change in the GDPPI
- X is a 1% “required” efficiency offset
- Z factor incorporates extraordinary costs

OEB Staff Proposal

- X-factor
 - Based on broader industry indices without reference to efficiency improvements in electricity distribution in Ontario.
 - Common across utilities without any attempt to differentiate productivity.

- Future capital expenditures are not incorporated.

Assessments and Recommendations

- ❑ The price-cap mechanism proposed by Board staff is simple and transparent, thereby easing regulatory burden for the regulator and for utilities.
- ❑ However, insufficient thought has been given to adapting it so that it is effective for public sector firms and in particular for Ontario distribution utilities.

Assessments and Recommendations

- ❑ More specifically, the proposal does not investigate how incentives will be created to promote:
 - ❑ further cost reductions
 - ❑ efficient capital expenditures
 - ❑ further rationalization within the industry.

Assessments and Recommendations

- ❑ The proposed mechanism is not linked to the more permanent one to follow.
- ❑ Utilities may have a disincentive to achieve further efficiency improvements at this time if the resulting cost savings could be “clawed back” in the near future through rebasing.
- ❑ A mechanism which ensures that utilities continue to benefit from cost savings for a substantially longer period of time should therefore be considered.

Assessments and Recommendations

- ❑ Regulatory and especially political stability should be a more prominent objective.
- ❑ Increased stability of the regulatory and policy environment has important benefits:
 - ❑ Improved incentive creation.
 - ❑ More effective planning and capital investment.
 - ❑ Reduced financial market risk and uncertainty.
 - ❑ Encourages further rationalization.

Assessments and Recommendations

- ❑ Regulatory uncertainty and political risk have important implications for continued industry restructuring and consolidation.
- ❑ Utilities need to be assured that benefits from mergers can be retained for a reasonable period of time, particularly in view of the significant transition and transactions costs.

Assessments and Recommendations

- ❑ Empirical analyses of the cost of capital which ignore the political and policy risks faced by distribution utilities likely underestimate the cost of capital.

Assessments and Recommendations

- ❑ Little effort has been devoted in this proceeding to assessing distributor productivity and efficiency, or to the impacts of capital programs on distributor costs.
- ❑ The proposed price-cap rule thus constitutes rebasing of certain components of costs without rebasing of others.

Assessments and Recommendations

- ❑ Ontario distribution utilities have been under a form of price-cap regulation and informal yardstick competition for an extended period of time.
- ❑ In addition, a number of utilities face major capital refurbishment and expansion programs.
- ❑ It may therefore be appropriate to delay implementation of the *K*-factor component and to rely upon a price-cap rule of the form

$$\% \Delta P = \% \Delta GDPPI - X + Z .$$

Summary and Conclusion

Incentive Creation Is the Key to Incentive Regulation

1. The proposed price-cap rule is likely to have limited impact in generating further efficiency improvements and productivity gains.
2. Additional mechanisms for incentive creation are needed. One such mechanism would ensure that utilities benefit from efficiency improvements – be they through improved productivity or mergers – for a reasonable period of time. In short, ***savings that are attained need to be retained.***
3. Political and policy environment risk has deep implications for efficiency improvement, incentive regulation, industry rationalization, capital and financial planning, and for the capital markets within which utilities operate. Provincial governments cannot expect the regulator to promote a healthy, reliable and efficient electricity distribution industry through incentive regulation, and at the same time harvest the rewards for other purposes.
4. The proposed price-cap rule rebases capital costs without rebasing other cost components. It would therefore seem appropriate to delay implementation of the *K*-factor. Moreover, during the interim period, consideration needs to be given to utilities with growing capital program costs.